A Closer Look at the S&P 500

Mutual funds that seek to match the performance of the S&P 500 index are of particular interest to many investors. These investors often believe the S&P 500 is a passively managed, broadly diversified index composed of the 500 largest companies in the U.S. equities market. This belief is mistaken.

What You May Not Know About the S&P 500

Before you commit your money to any investment opportunity, you need to know everything you can about the vehicle. The following list highlights a handful of key points many investors may not know about index funds based on the S&P 500.

Index funds based on the S&P 500 are NOT passive investments.

Investment strategies that involve the purchase of index funds are often called “passive” strategies. This label comes from the idea that an equity index is composed of a specific set of stocks and that no effort is made to alter this composition through stock selection.

When mutual fund companies promote “passive” investing, they correctly imply that their money managers attempt to track a given index and do not actively select stocks. What isn’t widely known is that, for S&P indexes, a committee at Standard & Poor’s picks the stocks—and the committee doesn’t just select the 500 largest stocks in the U.S. equity market.

The S&P 500 is NOT composed of the 500 largest stocks traded in the U.S. equity markets.

The committee at Standard & Poor’s picks stocks for inclusion in the index based on criteria that are not strictly related to tracking the performance of the 500 largest publicly traded U.S. stocks. The *General Criteria for S&P U.S. Index Membership*, released by the McGraw-Hill Companies, Inc. (parent corporation of Standard & Poor’s), states that, “S&P Indices are not rules based; all changes are fully discretionary and are determined by the Index Committee.” Stocks are not selected based on size, but instead are chosen to represent industries deemed important by the committee.

The S&P 500 is NOT just an index tracked by Standard & Poor’s; it is a product they sell.

The S&P 500 is a product that generates $80 million in licensing fees each year, according to *Institutional Investor Magazine (5/14/02)*. To keep those fees flowing, Standard & Poor’s needs to make sure the index reflects popular securities—the securities investors are buying. This effort to remain relevant in the marketplace has a notable impact on the index.

For example, if investor dollars are chasing tech stocks, tech stocks will rise in price, and the S&P index will add techs to the index. Likewise, the index removes companies when investors shy away from them. Enron, Global Crossing and WorldCom are all examples of securities dropped from the index when they lost favor with investors.

Efforts to steer the index toward popular securities often result in the decision to add stocks to the index after they experience considerable price growth. Historically, this strategy results in a concentrated position in overvalued issues. Energy companies dominated the S&P 500 in the 1970s-1980s. Consumer companies took over in the early 1990s. Techs rule the roost today, but their dominance has started to wane.

In a high-profile effort to correct the most recent imbalance, Credit Suisse Group replaced Compaq. Why would a bank replace a computer company? Because the investment committee decided technology stocks had lost favor with investors. Similar additions and deletions are fairly common, with the S&P 500 averaging 30-40 changes per year. The first-quarter of 2002 saw more than half-a-dozen changes, including Rational Software replacing power generator Niagara Mohawk, financial firm ACE Limited filling the vacancy created by the merger of materials/paper providers Mead Corp. and Westvaco Corp., and Plum Creek Timber replacing ailing retailer Kmart.

Each of the stocks in the S&P 500 does NOT have an equal impact on performance results.

The S&P 500 is a capitalization-weighted index. The greater the value of a company's stock, the greater the impact of that stock on the index. For example, the stock of a $20 billion company will have one-tenth the impact of the stock of a $200 billion company.

The S&P 500 is NOT entirely composed of U.S. companies.

Since the S&P 500 is often viewed as a proxy for the U.S. markets, many people are unaware that the quest for popular, big-name securities isn't limited to U.S. companies. The index includes a handful of foreign companies, including Alcan Aluminum, Nortel Networks, Royal Dutch Petroleum, Seagram and Unilever N.V. It also includes offshore companies, such as Global Crossing, Carnival and Tyco International, that do business in the U.S., but are registered outside the U.S. for tax purposes.

Know What You Buy, Before You Buy It

So, what does it all mean? Is indexing a bad strategy? Not necessarily. If the characteristics of a given index match your investment needs, an index fund may provide a suitable, low-cost way to participate in the financial markets. Index funds may not be the best choice if you are a high-net-worth investor, are concerned about capital gains taxes, are in a high income tax bracket, or have a sophisticated financial situation such as significant stock holdings or stock options in a single company. The decision to invest in an index fund is no different than the decision to select any other investment strategy. Make sure you understand the pros and cons of the strategy before you make your choice.